BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA
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Order Instituting Rulemaking on the Commission's Own Motion to Assess and Revise the Regulation Of Telecommunications Utilities.	))))	Rulemaking 05-04-005 (Filed April 7, 2005)

OPENING COMMENTS OF VERIZON CALIFORNIA INC. (U 1002 C)

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Verizon California Inc. ("Verizon") submits these Opening Comments pursuant to the Order Instituting Rulemaking in this proceeding (the "OIR").

I. INTRODUCTION

California once led the nation towards a progressive telecommunications policy. But today it lags behind, mired in regulations designed for a wireline-only world that existed over a decade-and-a-half ago. Many other states have recognized that competitive and technological advancements have fundamentally transformed the industry and have responded by substantially scaling back outdated economic regulation of incumbents, principally by removing price caps, price floors, and constraints on bundling of services. Until now, however, California has failed to respond.

This OIR gives the Commission the opportunity to put California back on track. The status quo is not an option. At a time when the telecommunications industry is in significant transition, continuing asymmetric application of economic regulation for wireline incumbents—but not their competitors—results in a system that, ironically, obstructs or even prevents *all market participants* from robustly competing and fully investing in the network of the future. In this context, this Commission's failure to act itself affects the market and depresses its progressive development. As long as any single competitor is constrained in its ability to respond quickly to consumer demand; offer new services and new bundles; innovate; provide leading-edge technologies; respond to other competitor's moves; and realize the full risks and rewards of their actions, competition as a whole suffers. And so do consumers.

The Commission must act now to remedy this problem. True reform can only be accomplished by a complete overhaul of California's telecommunications regulatory framework, transforming it from a complex, bureaucratic system to one that is streamlined, forward looking, and fundamentally market-based. To achieve that goal, the Commission should take a bottoms-up approach—that is, start with a clean slate and determine whether any regulatory rules must be added—rather than a tops-down approach of tinkering with an already-obsolete NRF plan that should be put to rest. This OIR provides the Commission with the opportunity to achieve such a result, with California's consumers being the principal beneficiaries.

To that end, Verizon proposes a uniform regulatory framework that removes unnecessary pricing constraints for most retail services and ends earnings regulation of incumbents. As additional safeguards to the pricing discipline that the competitive market offers, existing price caps would be retained only for basic residential (R1) and single line business (B1) and access services, and statewide rate uniformity would be maintained for retail tariffed services. The need for these additional safeguards would be reviewed in three years, during which time the Commission would monitor the state of the market through a streamlined monitoring regime based largely on FCC ARMIS reports.

Such a proposal offers a balanced approach to regulation and is consistent with the goals of the OIR. By substantially reducing the regulatory disparity that currently exists between market participants, Verizon's proposal promotes competitive and technological neutrality. By removing the regulatory risk associated with earnings regulation and pricing constraints, Verizon's proposal would encourage investment and innovation. And by promoting robust competition while adding the redundant safeguards of price caps for basic services and statewide rate uniformity, Verizon's proposal would best ensure, to the extent practical, access to modern, affordable, and high-quality telecommunications service for all Californians. In short, Verizon's proposal would allow California, once again, to lead the way towards a progressive telecommunications policy.

II. SUMMARY OF VERIZON'S PROPOSED UNIFORM REGULATORY FRAMEWORK

A. PROPOSED PRICING RULES.

Verizon proposes a uniform regulatory framework in which regulated intrastate services would be priced as follows:

- **Price-regulated services.** These would include only basic residential (R1) and business (B1) service, Lifeline, switched and special access, and E911 and would be capped at current rates for a 3-year transition period. Price increases would require Commission approval, but would be permitted in response to Commission-mandated price decreases to any other price-regulated service. Full downward pricing flexibility would be permitted, effective on 1-day Advice Letter ("AL") filing.

- **Non-price-regulated services.** Full pricing flexibility would be permitted for all other intrastate, retail services. Price increases would be effective on 30-day AL filing and 25-day prior customer notice. Price decreases would be effective on 1-day AL filing.

- **Bundles and promotions.** Price regulated (*e.g.*, R1 and B1) and non-price regulated services, including affiliate services, could be offered on a bundled or promotional basis without restriction (*e.g.*, time limitation) and would be accorded full pricing flexibility.

- **New services.** New services could be introduced by 30-day AL filing and would be accorded full pricing flexibility.

- **Contracts.** Individual Case Basis ("ICB") contracts would be effective on their own terms and would be filed with the Commission within 30 days of execution. No cost support would be required.

- **Wholesale.** No wholesale services beyond switched and special access are at issue under Verizon's proposal.

- **Statewide rate uniformity.** As an additional safeguard for customers in rural areas, Verizon proposes statewide rate uniformity for retail tariffed services.

- **AL filings and tariffing.** Any required AL filings could be protested only for improper noticing or filing procedures, and no cost support would be required. Tariffs would continue to be filed for all intrastate regulated services.

B. RELATED ELEMENTS: EARNINGS, MONITORING, AND AUDITING.

In addition to these pricing rules, Verizon's proposed uniform regulatory framework contains the following related elements:

- **Earnings Regulation.** Earnings regulation, including California-specific "ratemaking" adjustments and the NRF earnings-sharing mechanism, would be ended; and the Commission would no longer monitor earnings beyond any FCC ARMIS reporting requirements.

- **Gain on sale.** Shareholders would retain all gains on sale of assets, regardless of the type of asset or when it was purchased.

- **Monitoring.** Existing NRF monitoring reports would be replaced largely by FCC ARMIS reports and supplemented with limited URF-specific reports, to be determined in Phase 2, with the goal of promoting competitive neutrality, avoiding duplication, and eliminating any remaining vestiges of cost-of-service regulation.

- **Auditing.** Periodic staff review of the accuracy of FCC ARMIS reporting, supplemented with any URF-specific reports determined in Phase 2, would replace the large-scale financial and affiliate "ratemaking" audits conducted under NRF and would satisfy any auditing requirements under the Public Utilities Code.

III. THE RATIONALE FOR VERIZON'S PROPOSED UNIFORM REGULATORY FRAMEWORK

A. INTERMODAL COMPETITION HAS TRANSFORMED CALIFORNIA'S TELECOMMUNICATIONS MARKET.

Although groundbreaking when it was first adopted in California in 1989, NRF did not anticipate the extraordinary competitive transformation that the telecommunications market would witness over the next sixteen years. On the contrary, NRF was written in a wholly intramodal context where competition was limited primarily to the intraLATA toll market and further competitive development was dependent on increased access to incumbent networks. In this context, "competition" was merely incidental to NRF, whose principal purpose[1] was to promote regulatory streamlining and economic efficiency in a wireline-only world.

Today's telecommunications market, however, has expanded beyond these narrow confines. Intermodal competitors offering a suite of telecommunications services—ranging from the "triple play" of voice, video, and data offered by cable, to unlimited, "all distance" plans offered by wireless, to e-mail, instant messaging, and

[1] See accompanying Declaration of Timothy J. McCallion ("McCallion Declaration") (May 31, 2005) at ¶ 10; Declaration of Dr. Debra J. Aron ("Aron Declaration") (May 31, 2005) at ¶¶ 8, 23.

VoIP offered over broadband—now compete head-to-head with incumbents like Verizon.

Because these intermodal competitors do not depend on incumbent networks to provide service, the extent of competition cannot be determined from traditional, wireline-only market analyses. Instead, as Dr. Aron discusses in greater detail, an accurate assessment of competition in today's dynamic market requires examining whether competitors "have the ability—actual or potential—to take significant amounts of business away from each other."[2] Thus, when determining whether a particular service counts as competition for incumbent wireline services, one needs to determine, from the consumer's viewpoint, the extent to which one service may serve a comparable—not identical—function as another and thereby serve as a constraint on pricing. Dr. Aron describes this concept as "reasonable interchangeability," which she notes has been used both by the Supreme Court and the FCC.[3]

Nor is it necessary for all customers to view two services as reasonably interchangeable to provide effective competition. While some customers, for example, may not consider wireless to be a good substitute for incumbent wireline service, if enough customers would consider cutting the cord, then it would exert pricing discipline on wireline service. "One of the powerful virtues of competition," Dr. Aron notes, "is that when one service exerts competitive pressure on another, all consumers benefit, even those who would never consider switching."[4]

Applying these principles, Dr. Aron concludes that intermodal competition in California is "not a promise, it is here."[5] Perhaps the most compelling of market-wide data Dr. Aron cites to support her conclusion comes from a Deutsche Bank telecommunications substitution study analyzing ILEC, CLEC, VoIP, cable, and wireless

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[2] *SmithKline Corp. v. Eli Lilly & Co.* (3rd Cir. 1978) 575 F.2d 1056, 1063, discussed in Aron Declaration at ¶ 47, *et seq.*

[3] See Aron Declaration at ¶ 44, *et seq.*

[4] *Id.* at ¶ 48.

[5] Aron Declaration at ¶ 27.

data from the first quarter of 2003 through the third quarter of 2004. The study shows that wireless growth accounted for about *47 percent of ILEC primary line residential landline losses* (as measured relative to where ILEC residential primary lines would have been, after accounting for economic growth), with the other 53 percent being lost to CLECs, cable telephony, and VoIP. The study projects that ILECs will continue to lose lines at a rate in excess of 4 percent per year and finds substantial risk that losses could exceed 5 or even 6 percent per year. These losses, in turn, could decrease the value of incumbent equity by about 15–20 percent or more.[6]

Dr. Aron then shows how a platform-by-platform analysis of available data for wireless, VoIP, and cable supports her conclusion that intermodal competition in California is a reality and is applying competitive pressure on wireline incumbents.

1. Wireless.

Dr. Aron shows how wireless is leading the intermodal assault on ILECs in California, citing numerous sources showing broad wireless penetration and significant wireless substitution for wireline access. Her comprehensive discussion includes statistics from the FCC's 2004 Local Competition Report,[7] showing that:

- The number of landlines in California decreased by 1.57 million from end-of-year 2001 to June 2004, while during the same period, the number of wireless subscribers in California increased by 6.52 million.
- There are now more wireless subscribers in California than there are incumbent access lines, and nearly as many wireless subscribers as all wireline (ILEC and CLEC) switched access lines combined.
- In the past five years, wireless subscribers in California have increased by 152 percent, while ILEC landlines have declined by 21 percent.
- There are 15 operating wireless carriers, a count exceeded only in Texas.
- Mobile wireless penetration in California has exceeded the national average of 71 percent.

[6] See Aron Declaration at ¶¶ 64, 68, citing Viktor Shvets, Nigel Coe, and Andrew Kieley, "Crossing the Rubicon, Act II: Indian summer wanes," Deutsche Bank Global Equity Research Analyst Report—Wireline Industry, November 26, 2004 ("*Deutsche Bank November 2004*").

[7] See Aron Declaration at ¶¶ 62, 70, 71, analyzing data from the FCC's 2004 *Local Competition Report*, Tables 8 (CLEC Lines), 9 (ILEC lines), and 13 (wireless subscribers).

2. VoIP.

Dr. Aron shows how VoIP poses an even greater threat to ILECs since VoIP not only has a foothold in the market, but its going-forward penetration projections are nothing short of staggering. In support of these projections, Dr. Aron cites numerous sources showing that:

- Nationwide, at the end of 2004, there were over a million VoIP connections (including cable VoIP) capable of placing voice calls to, and receiving calls from, the public switched telephone network.[8]
- This number is expected to approximately double each year from end-of-year 2004 to end-of-year 2008, thereby serving 17.5 million U.S. households by 2008, and increasing (though at a slower growth rate) thereafter.[9]
- Vonage, the largest independent VoIP provider, is adding VoIP lines at a rate of *15,000 per week* (or about 180,000 per quarter) based on its own reporting from the first quarter of this year, even though it only began offering VoIP services to the mass market in January 2001.[10]
- Comcast, which already offers circuit-switched-based telephone service to about 1.3 million customers nationwide, is expected to offer VoIP to all 40 million households that its network currently passes by 2006, leading at least one prominent investment analyst to predict that Comcast will emerge as one of the nation's largest telephone companies.[11]
- Cox offers VoIP service that it markets as a high-quality, full-featured primary line substitute that provides access to E911, concluding in a recent white paper that its service is "ready for prime time."[12]
- There are one or more VoIP providers (not including Verizon's VoiceWing VoIP service) offering local telephone numbers associated with every Verizon wire center in California except one.[13]

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[8] See Aron Declaration at ¶ 74, citing "The Yankee Group Expects the Consumer Local VoIP Industry to Grow More Than 100 Times Its 2003 Size," The Yankee Group, News Release, August 30, 2004, downloaded October 6, 2004 from <www.yankeegroup.com> ("*Yankee August 2004*").

[9] See Aron Declaration at ¶ 74, LECG computations based on *Yankee August 2004*. See also, Viktor Shvets, Nigel Coe, and Andrew Kieley, "Voice over IP: Loud rumblings," Deutsche Bank Global Equity Research Analyst Report, February 25, 2004 ("*Deutsche Bank February 2004*").

[10] See Aron Declaration at ¶¶ 8, 24, citing "Vonage® Becomes First Broadband Telephony Provider To Activate Over 500,000 Lines," Vonage Press Release, March 7, 2005, downloaded May 26, 2005 from <www.vonage.com/corporate/press_index.php?PR=2005_03_07_1>.

[11] See Aron Declaration at ¶ 79, citing Comcast Corporation Form 10-K for the fiscal year ending December 31, 2003 and Michael Learmonth, "UPDATE 3 – Comcast to offer phone service to 40 mln in 2006," Reuters, May 26, 2004.

[12] See Aron Declaration at ¶ 79, citing "Voice over Internet Protocol: Ready for Prime Time, Cox Communications' Successful Deployment of VoIP," Cox Communications white paper, May 2004.

[13] See Aron Declaration at ¶ 102, analyzing data from VoIP provider websites.

3. Cable.

Finally, Dr. Aron shows how cable providers have made substantial inroads in providing local exchange service to residential and business customers in California and nationwide, citing numerous sources showing that:

- Cox has very high take rates for its telephony offering for customers who also subscribe to Cox's cable service, noting in a recent news release that in Orange County "40 percent of consumers subscribe to Cox Digital Telephone, and 82 percent of [Cox] phone customers elect Cox for their long distance service."[14]
- As of March 2005, Cox had 100,000 business customer locations across the 17 markets nationwide in which its digital phone service was available.[15]
- Deutsche Bank projects that nationwide, cable telephony will add 500,000–600,000 voice lines per quarter this year and 800,000–900,000 lines per quarter in 2006.[16]

B. INTERMODAL COMPETITION HAS SUBSTANTIALLY IMPACTED VERIZON'S BUSINESS.

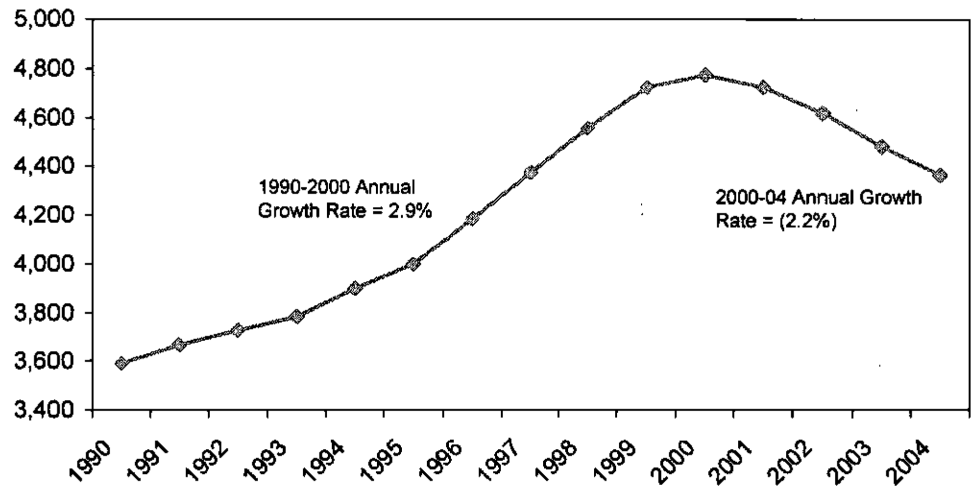
The intermodal transformation that Dr. Aron discusses has had a profound impact on the business of being an incumbent wireline provider. Verizon, for example, has seen substantial declines in its three largest revenue generating services since 1990: local toll, switched access, and billable switched access lines. Perhaps the best evidence of this intermodal impact is shown in Verizon's access line count, which as Mr. McCallion discusses, shows a dramatic decline beginning in 2000, even when accounting for UNE-P and resale lines:

[14] See Aron Declaration at ¶ 83, citing "Cox Brings Telephone to Five New Markets in '05," Cox Communications News Release, March 8, 2005.

[15] See Aron Declaration at ¶ 84, citing "Circuit Switch to VoIP Evolution Plan," Cox Communications white paper, March 2005.

[16] See Aron Declaration at ¶ 27, citing *Deutsche Bank November 2004*.

Verizon California Inc. Total Billable Switched Access Lines (In Thousands) (Including UNE-P and Resale)[17]



This chart shows that that Verizon's intramodal wireline growth, *i.e.*, Verizon retail access lines *plus* Verizon wholesale UNE-P and resale access lines, has almost completely reversed its historical trend, declining 2.2% since 2000. In fact, had the 2.9% annual growth of the 1990s continued into the 2000s, Verizon would have had nearly 20% more switched access lines in 2004 than it actually did.

Dr. Aron reaches a similar conclusion in her analysis of Verizon's retail line data by wire center from December 2003 through March 2005.[18] She concludes that the magnitude of Verizon's retail line losses during this period is significant and widespread, affecting small (less than 10,000 retail lines), medium (between 10,000 and 30,000 lines), and large wire centers (over 30,000 lines). Over the 15-month period, Verizon has lost 10 percent of its retail lines, and within each of the three categories of wire centers, Verizon has experienced line loss exceeding 7 percent. Furthermore, these losses have affected each of the identified line types—primary residential, additional residential, and business lines. While the loss has been most pronounced on residential secondary lines, which declined overall by a remarkable 22 percent, residential primary lines and business lines fell by substantial amounts, as well. Overall,

[17] Data from FCC ARMIS Report 43-08.

[18] See Aron Declaration at ¶ 105.

residential primary lines and business lines declined by 8.5 and 8.8 percent, respectively, during the 15-month period.

This data is clear evidence of the profound impact that competition from intra- and intermodal providers has had on Verizon's wireline business.

C. THE INTERMODAL TELECOMMUNICATIONS TRANSFORMATION HAS CREATED AN URGENT NEED TO ELIMINATE "ANTICIPATORY REGULATION" OF INCUMBENTS.

California's regulation of incumbents like Verizon has not kept pace with the intermodal transformation of the telecommunications market. The result is widely disparate regulatory treatment between market participants.

ILECs, on the one hand, are subject to a web of complex and burdensome economic regulations under NRF, including price caps and price floors, earnings scrutiny, promotional and bundling constraints, inconsistent state and federal financial reporting requirements, and comprehensive "ratemaking style" audits. Mr. McCallion describes this system as "anticipatory regulation"—where regulators think of various things that could possibly go wrong and write rules to prevent them from happening in the first place.

CLECs and other intermodal competitors, on the other hand, are free to compete with little or no economic regulation by the Commission.

As Dr. Aron describes in greater detail,[19] this decidedly *non*-uniform regulatory framework harms California and its consumers by distorting robust competition and discouraging investment and technological innovation. California should move away from this old regime towards a system that lets all market participants compete in this dynamic new telecommunications market free from unnecessary "anticipatory regulation."

To achieve this result, the Commission should take a bottoms-up approach to regulation—that is, it should start with a clean slate and determine whether any regulatory rules must be added—rather than a top-down approach of tinkering with an

[19] See, e.g., Aron Declaration at ¶¶ 4, 33, 124, 137, 172, 184, 189.

already-obsolete NRF framework. Dr. Aron shows that such a bottoms-up approach to regulation is warranted in light of:

- The competitive state of today's dynamic telecommunications market;
- The fundamental inability of regulation to advance consumer welfare better than competition itself;
- The wholesale regulatory obligations and safeguards that are imposed on incumbent telecommunications providers by the federal Telecommunications Act;
- The material costs and burdens of imposing a regulatory infrastructure; and
- The distortion that regulation has on existing competition and investment.[20]

Verizon's proposed uniform regulatory framework is consistent with the bottoms-up approach Dr. Aron calls for and should be adopted.

D. VERIZON'S PROPOSED UNIFORM REGULATORY FRAMEWORK WILL BEST MEET THE GOALS OF THIS OIR.

1. A "light handed touch" to regulation is the best approach.

In addition to being consistent with the bottoms-up approach Dr. Aron recommends, Verizon's proposed uniform regulatory framework would, if adopted, best meet the goals of the OIR. Specifically, with its call for greater competitive and technological neutrality, limited price regulation for basic services, and statewide tariffed rate uniformity, Verizon's proposal will, by design, promote more robust competition among all market participants and spur further technological innovation, economic development, and employment in California. The result, as Mr. McCallion discusses,[21] will be a system that best ensures, to the extent practical, access to modern, affordable, and high quality telecommunications services for all Californians. In short, the light-handed touch that has been successfully applied to intermodal providers should be expanded to ILECs, with the principal beneficiaries being California's consumers.

[20] See Aron Declaration at ¶148.

[21] See McCallion Declaration at ¶¶ 2, 9, 35–39.

The economic soundness of such a light-handed touch is clear and strong. As Dr. Aron discusses in greater detail,[22] Verizon's proposal offers the Commission an opportunity to unleash the potential that today's competitive market offers. By lifting legacy regulations that infiltrate much of their everyday business activities, incumbents like Verizon will not only be relieved of burdens that their intermodal competitors do not share. They will also be freed to devote their thinking, their talents, and their resources to finding more effective and creative ways to compete for the needs of consumers. This increased competition will discipline prices, promote affordability and access, and spur network investment.

Dr. Aron shows how light-handed regulation has achieved increased consumer benefits in other industries, citing a study by economist Robert Crandall:

Crandall Summary of Various Studies on Regulation: The Effects of Deregulation in the United States[23]

Sector	Nature of Deregulation	Consumer Benefit
Airlines	Total	33 percent reduction in real (inflation adjusted) fares.
Trucking	Total	35 to 75 percent reduction in real rates.
Railroads	Partial; rate ceilings and floors on "monopoly" routes.	More than 50 percent decline in real rates.
Natural Gas	Partial; distribution still regulated.	30 percent decline in consumer prices.
Telecommunications	Partial; local rates and interstate access charges still regulated.	More than 50 percent decline in long distance rates.
Banking	Consumer rates deregulated; entry liberalized.	Increase in rates on consumer deposits; improved productivity.

Similarly, Dr. Aron discusses how economist Thomas W. Hazlett, in an examination of the period when some states regulated wireless service rates, found that

[22] See, e.g., Aron declaration at ¶¶ 4, 147, 160–178.

[23] Aron Declaration at ¶ 135, citing Robert W. Crandall, "An End to Economic Regulation?" draft white paper. Final published in *Competition and Regulation in Utility Markets*, Collin Robinson (ed.), Institute of Economic Affairs, May 1, 2003.

wireless penetration was some 1.7 times higher in states where there was no rate regulation as compared to states where there was rate regulation; and that wireless subscriptions grew faster in the non-price-regulated states than in price-regulated states.[24]

2. The specific components of Verizon's proposal are economically sound and consistent with the OIR's goals.

In addition to discussing the general benefits of Verizon's uniform regulatory framework, Dr. Aron shows how each of the specific elements of Verizon's proposal is economically sound and consistent with the goals set forth in the OIR. The main elements of Verizon's proposal and Dr. Aron's conclusions are summarized here:

a. Price caps for basic services only; statewide rate uniformity for retail tariffed services.

Under Verizon's proposal, price-regulated services would be generally limited to basic residential and business services (R1 and B1) and would be subject to existing price caps for a three-year transition period. In addition, statewide rate uniformity would be maintained for retail tariffed services. Although in Dr. Aron's view such pricing constraints are unnecessary from the perspective of sound economics (and in fact may impede the full realization of the benefits of competition), she concludes that it would nevertheless provide additional assurances that the increased pricing flexibility in Verizon's proposal will not harm consumers or lead to predation.[25] As such, price caps for basic services and statewide uniformity for retail tariffed rates are reasonable redundant safeguards to maintain for a limited period during which the Commission can monitor the market to confirm that they should be phased out after three years.

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[24] See Aron Declaration at ¶ 138, citing Thomas W. Hazlett, "Regulating Wireless Phones in California: An Economic Analysis," April 9, 2003, Figure 9 at 36, downloaded from <www.pacificresearch.org/pub/sab/techno/wireless/HazlettPaper.pdf>.

[25] See Aron Declaration at ¶¶ 207–210.

b. No price floors for any retail services.

Under Verizon's proposal, all retail services, including basic residential and business services, would be accorded full downward pricing flexibility. Dr. Aron concludes that this proposal advances the OIR's goals of competitive and technological neutrality and affordability of service and is consistent with a fundamental objective of competition itself, *i.e.*, that firms not be discouraged from offering price decreases, even if such price decreases may harm particular competitors. Robust price competition is the essence of competition and should be encouraged in any uniform regulatory framework.[26]

A contrary policy would have the effect of preventing wireline incumbents from competing effectively with intermodal competitors, which are not subject to price floors. Such a result, Dr. Aron shows,[27] would be inconsistent with the goal of competitive and technological neutrality, and would harm not only the incumbents themselves, but also consumers, who would be denied the lowest prices that would otherwise prevail in the absence of comfortable price "umbrellas," under which competitors can artificially price their services free from the (legitimate) threat of incumbent price competition.

Nor is there any need to impose price floors to prevent predatory pricing. Dr. Aron shows the California telecommunications market is not conducive to predation, due in large part to the fact that intermodal competitors have significant sunk investments in California, making it both difficult to drive them out of the market and relatively easy for them to re-enter since their investments remain in place. In other cases, such as with independent VoIP providers, the costs of entry are relatively low, therefore a predation strategy is unlikely to succeed.[28] Imposing price floors based on the wholly speculative and highly improbable "danger" of predation would only harm consumers by preventing incumbents from engaging in robust price competition with intermodal providers, as discussed above.

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[26] See *id.* at ¶¶ 188–191.

[27] See *id.* at ¶ 189.

[28] See Aron declaration at ¶¶ 179–184.

And even if price floors were necessary, which they are not, it be not be practical for the Commission to determine what an appropriate price floor would be since intermodal competitors do not utilize incumbent wireline networks to provide service, and therefore, there is no consistent cost basis among them to determine an appropriate floor.

c. Full pricing flexibility for all retail services except basic residential and single-line business services.

Under Verizon's proposal, all other retail services would be accorded full pricing flexibility. Dr. Aron concludes that this proposal is based on sound economic principles and advances the goals set forth in the OIR, namely, it is competitively and technologically neutral; promotes access to and affordability of service; and encourages technological innovation, economic development, employment, and the development of a modern, high-quality telecommunications network in California.[29]

As Dr. Aron shows, the pricing flexibility Verizon is proposing permits all market participants to compete under more uniform rules, and with similar flexibility so that, like other firms in competitive industries, their focus can be on demand conditions, costs, and competition, rather than regulatory restrictions and filing requirements.[30] Verizon's proposal better aligns the firm's incentives with the OIR's goals to produce more efficient prices, consistent with the development of efficient competition and optimal investment. Indeed, it is one of the most fundamental tenets of economics that when the market is competitive, market forces can determine efficient pricing and promote social welfare far more effectively than can the most diligent and knowledgeable regulator.[31]

Nor would it be benign to impose pricing restrictions on the mistaken belief that "prices only go down in competitive markets."[32] In markets where product differentiation

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[29] See *id.* at ¶¶ 160–172.

[30] See Aron Declaration at ¶¶ 13, 160, 163.

[31] See *id.* at ¶ 133.

[32] See *id.* at ¶ 163.

and technological innovation are important, such as in telecommunications, prices will go up and down as firms respond to the innovations of other competitors and find ways to meet the various needs and desires of customers. This process of trial and error may involve a proliferation of pricing plans, a contraction of pricing plans, experimental offerings, and new innovations.

To the extent pricing constraints are imposed, it impedes the firm's ability to try and meet the full needs and desires of its customers, who are thereby harmed. The Commission recently recognized this principle in its discussion of bundling in the Broadband Report, "Laws and regulations that discourage bundling of services impede the competitive pressures that result in lower prices for consumers."[33] Verizon's proposal properly avoids such constraints, offering a level playing field for all market participants to compete robustly for the business of California's consumers, to their manifest benefit.

d. Revenue neutrality for price-regulated services.

For a truly competitive market to function efficiently, one set of competitors should not be subjected to government-mandated costs that are not imposed on another set of competitors. Verizon addresses this issue through its proposal for revenue neutrality to be applied to services that would remain price-regulated, *e.g.*, basic residential and business services and switched access.

The Commission defines "revenue neutrality" as follows:

> [E]very rate change ordered by [the Commission] which results in a revenue increase or decrease is offset by countervailing rate changes or revenue adjustments so that the cumulative effect of all revenue changes for each NRF company is zero (revenue neutrality).[34]

Dr. Aron shows how maintaining revenue neutrality in the context of Commission-imposed price changes plays an important role in preserving the high-

[33] California Public Utilities Commission, *Broadband Deployment in California* (May 5, 2005) at 82.

[34] D.94-09-065, *mimeo* at § 1.

powered, pro-competitive incentives arising from its proposed uniform regulatory framework. These incentives—to improve operating efficiency, respond to the demands of its customers, and innovate in response to competitive pressures—are most effective if the firm is reasonably assured that it will not be denied the benefits of these incentives through future Commission-imposed price decreases on price-capped services.[35]

For example, were the Commission to decrease regulated intrastate switched access charges in order to bring prices more closely in line with the costs of that service, without providing offsetting pricing flexibility in other price-capped services, the Commission, in effect, would be reintroducing a link between the incumbent's costs of service and price. Such a decision would undermine the high-powered incentives fostered by the proposed uniform regulatory framework, discouraging efficient behavior. It would give the Commission an avenue for manipulating incumbents' earnings, despite an otherwise (seemingly) market-oriented and technology-neutral regulatory policy.

Revenue neutrality for price-regulated services offers regulators the means to rebalance incumbents' regulated services in those instances where it is appropriate, without distorting the incentives fostered by a uniform approach. Such a result is based on sound economic principles and is consistent with the goals of the OIR.

e. Price changes by advice letter and customer notice.

For both price-regulated and non-price-regulated services, Verizon's proposal would allow price decreases by advice letter ("AL") effective 1 day after filing. For non-price-regulated services, price increases (or more restrictive terms) would be effective 30 days after AL filing and would require 25 days' prior customer notice, consistent with the uniform rules set forth in D.02-01-038, under which CLECs and IECs operate today.[36] There would be no requirement to provide cost support with the filings.

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[35] See Aron Declaration at ¶¶ 196–200.

[36] *See* D.02-01-038, *mimeo* at 2–3.

As Dr. Aron shows,[37] Verizon's proposal is consistent with the goal of promoting technological and competitive neutrality by bringing ILECs more in line with their intermodal competitors such as facilities-based CLECs, wireless, and VoIP carriers, whose price adjustments are disciplined largely by the market. Wireless and VoIP carriers, for example, are not required to provide any advance notification or justification to the Commission if they decide to adjust their prices (thereby tipping off their next move to their competitors); their only notification obligations (if any) are derived from customer contracts. As indicated above, CLECs and IECs are obliged to file advice letters for price changes and provide at least 25 days' advance customer notification for price increases (or more restrictive terms) only.

Elimination of the requirement to provide cost support with AL filings is consistent with the Commission's policy for NDIECs established in D.90-08-032, which should serve as a reasonable template for competitive services:

> Our policy continues to be that we are not regulating NDIEC rates on a cost of service basis. Accordingly, we do not provide for cost of service review as one of the functions that staff would perform in reviewing an NDIEC filing. Absent compelling comments to the contrary we intend to permit NDIEC rate reductions to proceed expeditiously without need for significant staff review. Competitors always have the complaint process available to address legitimate grievances about rate levels of other utilities.[38]

Finally, allowing valid protests for only improper noticing or filing procedures is the Commission's policy for NDIECs established in that same decision:

> We intend to be very critical of any protests of NDIEC rate increase that merely complain of increases in rates for competitively available services. The underlying purpose of the 30-day notice period for rate increases is not to stimulate complaints or protests, but instead to give a full opportunity to the NDIEC's customers to seek out competitive alternative providers of service if they wish to do so prior to the increased rates becoming effective.[39]

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[37] See Aron declaration at ¶¶ 194–195.

[38] 1990 Cal. PUC LEXIS 787, 12, *quoting* D.90-02-019.

[39] *Id.* at 17–18.

f. An end to earnings regulation and its associated burdensome scrutiny of potential California "ratemaking" adjustments.

Under Verizon's proposal, earnings regulation of incumbents would be ended, along with its related parts, *e.g.*, the earnings-sharing mechanism under NRF (which was suspended in the last triennial review of NRF) and related earnings monitoring and auditing for potential "ratemaking" adjustments. Such a result would remove a substantial regulatory risk that, like the Sword of Damocles itself, hangs over the heads of the ILECs, discouraging them from investing in California.

As Dr. Aron describes in greater detail,[40] it is a fundamental concept of sound economics that regulated firms will not make investments if they believe that the regulator will expropriate benefits of the investments after they have been made. Indeed, when a regulated firm faces such risk, it is discouraged from making investments in the first place, with the result that consumers are denied the benefits of services that would be provided by the investments, and for which they would be willing to pay. Permanently ending earnings regulation, therefore, will promote investment in California, resulting not only in economic development and job growth, but also a more modern, high-quality telecommunications network that all Californians will enjoy.

Permanently ending the earnings sharing mechanism is also consistent with the policy direction that the Commission outlined in its last triennial review of NRF:

> We expect permanent elimination as part of the evolution of our regulation in response to continued changes in the market. Moreover, permanent elimination will remove regulatory risk, and provide desirable certainty to the market.[41]

If, however, the Commission were now to reverse course and reinstate earnings sharing, it would demonstrate its willingness to expropriate earnings, and could be expected to cost the state of California investment funds, lost jobs, and lost consumer benefits of improvements in the telecommunications infrastructure. By squandering the credibility that California has built up through over a decade of NRF regulation, such an

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[40] See Aron declaration at ¶¶ 201–206.

[41] D.98-10-026, 1998 Cal. PUC LEXIS 669, 47.

action would send an adverse signal to investors that would go well beyond the specifics of this proceeding.[42]

Consistent with Verizon's proposal to end earnings regulation, the Commission should also eliminate further monitoring and auditing of ILEC earnings for potential California "ratemaking" adjustments. The mere presence of such scrutiny, which is not applied to CLECs or other intermodal competitors, serves as a deterrent to investment and a source of unnecessary burdens and litigation, and is inconsistent with the OIR's goal of competitive and technological neutrality. In Verizon's last audit, for example, ORA's outside auditor "submitted 937 formal written discovery questions, 159 verbal questions and interviewed and/or had discussions with 34 employees of GTEC and its affiliates"[43] over the course of 1-½ year period, with the primary purpose being to scrutinize the company's earnings for potential "ratemaking" adjustments. Despite this incredible work effort, the audit resulted in no measurable consumer benefit.

Such burdensome and disparate treatment of incumbents should end under any uniform regulatory framework that is adopted in this proceeding. Instead, as Mr. Cleverly discusses in greater detail,[44] the Commission should adopt the approach it instituted for AT&T in D.93-02-010, where periodic staff review of the accuracy of monitoring reports was found to satisfy any auditing requirements under the Public Utilities Code.

IV. IMPLEMENTATION OF VERIZON'S PROPOSED UNIFORM REGULATORY FRAMEWORK

In large part, Verizon's proposed uniform regulatory framework is self-effectuating and therefore can be implemented expeditiously without the need to address specific details in Phase 2 or in hearings. In terms of pricing, since Verizon's proposal calls for the removal of pricing restrictions for most services and the

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[42] See Aron declaration at ¶ 206.

[43] Larkin & Associates Audit Report, "Regulatory Audit of GTE California Incorporated and its Corporate Affiliates," (April 30, 2001) at 1–4.

[44] See Cleverly Declaration at § 4.

continuation of *existing* price caps for basic services only, there would be no costs to examine or floors or ceilings to set in Phase 2. Instead, the principal mechanism to implement Verizon's proposed pricing structure would be the tariff process, which, as a practical matter, each Respondent can manage on its own once a Phase 1 decision is adopted.

As Mr. Cleverly discusses in greater detail,[45] the only element of Verizon's proposal that requires implementation in Phase 2 would be the question of what URF-specific monitoring reports should be adopted to supplement the FCC ARMIS reports that would replace the existing NRF monitoring regime. This is a relatively straightforward issue that could be resolved expeditiously with policy guidance from Phase 1. Such URF-specific monitoring reports should avoid duplication and be limited to those that are consistent with the OIR's objectives and necessary to monitoring the effectiveness of the adopted framework.

Nor is there any need for the Commission to conduct evidentiary hearings prior to implementing a uniform regulatory framework such as the one Verizon has proposed. This case involves broad public policy considerations affecting "all providers of regulated intrastate telecommunications services" in California.[46] The California Supreme Court has recognized that the Commission is acting more in its legislative capacity in such cases, for which evidentiary hearings are not required.[47] The Commission's preliminary designation of this proceeding as quasi-legislative also supports this view.[48] Indeed, the *en banc* hearing already required by the OIR is the

[45] See Cleverly Declaration at § 3.

[46] OIR at 3.

[47] *See, e.g., Wood v. Public Utilities Com.* (Cal. Sup. Ct. 1971) 4 Cal. 3d 288, 292 ("In adopting rules governing service and in fixing rates, a regulatory commission exercises legislative functions delegated to it and does not, in so doing, adjudicate vested interests or render quasi-judicial decisions which require a public hearing for affected ratepayers.")

[48] *See, e.g., San Diego Gas & Electric Co. v. Superior Court*, 13 Cal. 4th 893, 950–951, *quoting Franchise Tax Board v. Superior Court* (Cal. Sup. Ct. 1950) 36 Cal. 2d 538, 549 (" 'There is no constitutional requirement for any hearing in a quasi legislative proceeding.' A fortiori, there is no constitutional requirement that all private parties who might conceivably be affected by the outcome of such a proceeding be given notice and opportunity to be heard.")

proper forum for the Commission to address any "legislative facts" that would help guide its consideration of the important policy issues driving this case.

V. CONCLUSION

In the final analysis, Verizon's proposed uniform regulatory framework offers a reasonable and balanced approach to competitively and technologically neutral regulation that will—once again—put California back in the forefront of a progressive telecommunications policy. California's consumers deserve no less. Verizon stands ready to work with the Commission towards that goal.

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